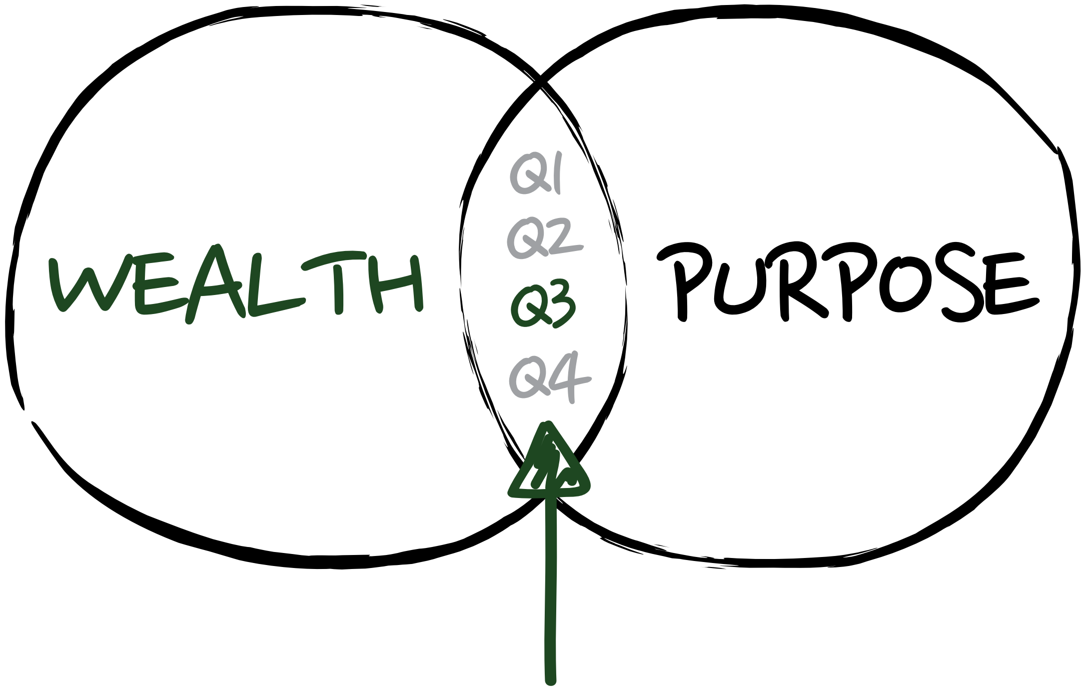

CONNECTING QUARTERLY

OCT. 2016

Dear Friends,

My 6-year old son has multiple food allergies. Before he reached the age of one, my wife and I were informed that if he eats even trace amounts of eggs, nuts, mustard, sesame or coconut he could suffer a life-threatening anaphylactic reaction. Because there's no treatment currently available, the best we can do for our son is review the ingredients of every food we buy, quiz servers and chefs at restaurants, coordinate with teachers and other parents around school treats and birthday party menus and try to tactfully educate our 1st grader about the five ingredients that have the potential to kill him. Of course, like every parent of a child with food allergies, we offset these feelings of helplessness by focusing our attention on all the other wonderful traits he has.

You can imagine our excitement a month ago when we read that a pediatrician at Stanford University was trying to launch a cutting-edge research project in hopes of developing a treatment for children with multiple food allergies. In the course of the next five days, we read everything we could find about the lead doctor's background and had

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phone conversations with the doctor and her team's "parent liaison" to understand the details of the research study they are hoping to conduct.

One morning over breakfast, we concluded we were going to do whatever we could to help the study get off the ground in hopes that it could potentially help our son and others like him. That afternoon, I called the parent liaison and agreed to make a financial contribution to the research group that was multiple times larger than any donation my wife and I had ever made to a charitable cause. Driving home that afternoon, I felt an amazing rush of excitement. I was grinning from ear to ear, the music was cranked up in my car and I felt like nothing in the world could bring me down from the high brought about by that week's activities.

A few days later, I reflected on that feeling: What had happened over those seven days that made me so euphoric? My son's allergies weren't any different, we were reading and carefully checking labels at Trader Joe's and we were still having to plan the "alternative" meal and treats we were going to bring to a birthday party that following weekend. Then it dawned on me: For one brief week, we had taken action and felt a feeling of CONTROL over our situation. WE were the ones finding the articles. WE were the ones reaching out to the doctor. WE were the ones making the financial commitment to try to help get the study off the ground. We were DOING SOMETHING, and I suddenly realized how powerful the feeling of being in control really is.

I'm guessing that everyone feels a similar rush when they've taken actions that make them feel in control. In cases like that of my family, quenching our thirst for control didn't have any negative implications. It made us happy, and someday maybe the study will launch. But in other aspects of our lives, unabashedly seeking that powerful feeling of control can have dangerous consequences.

Take investing. The process of investing is filled with things we don't control, around which we must make educated leaps of faith. We don't know whether the stock market will go up or down over the next 12 months or the next 10 years. We don't know which stocks will do well or poorly. We don't know whether interest rates will go up or down or when the next market decline will happen. No one does.

Despite these truths, many investors attempt to exert control over their investments in ways that put themselves at significant risk. They avoid investing because things feel too "uncertain" when in reality, the future has always been and will always be uncertain. They buy the stock of the glamorous company with the popular new product in an effort to chase past returns, only to be disappointed when the stock doesn't repeat its past success. When the market goes down 10%, they sell their stocks in an attempt to "stop the bleeding" when all they've really done is reduced the odds that the wound will heal. They choose expensive mutual funds and hedge funds under the premise that "you get what you pay for" when empirical data shows the exact opposite is true.[1,2]

There is an uncountable number of factors that drive the results we as investors achieve over our lifetimes, but there are only a precious few we control:

1. **The costs we choose to pay.** No one can predict with certainty whether one mutual fund or investment manager will outperform another. But we can get a very clear indication of which one costs more. That is not to say that the lower-cost option is ALWAYS better; it's a matter of trying to objectively evaluate whether or not the cost premium of one fund is likely to be offset by better results. In our experience, most of the time higher costs are not worth it to the investor.

2. **The risks we choose to take.** Greater expected returns are always a function of greater risk, but taking more risk doesn't always lead to better returns. Concentrating in a few stocks or hiring high-priced "active" managers are two risks which have generally not been shown to lead to higher long-term returns. But investing in a diversified portfolio of stocks has historically lead to greater long-term returns than investing in bonds. Not all risks are the same, and we should only choose to take the ones where there is clear evidence of an expected payoff.

3. **How we manage our emotions.** When our stock investments gyrate, as they undoubtedly will, how will we react? Will we get greedy and buy more after huge gains have occurred? Will we sell after a big decline, locking our losses? A number of studies have shown that the average investor costs himself 1-2% per year over the long-term by reacting inappropriately when the markets make them emotional.[3,4] That's a huge factor in our long-term wealth over which we, as investors, have complete control.

Trying to pick stocks and attempting to time the gyrations of the stock market may give us the illusion of being in control of our wealth. Taking action on a frequent basis can mitigate our feelings of helplessness and make us feel great in the short-term, just like my family did when we took actions that we thought could accelerate the pace of allergy research. The difference is that in the investing world, the actions we are most often tempted to take are those that generally detract from our long-term wealth, rather than improve it.

> Don't underestimate the value of DOING NOTHING, of just going along, listening to all the things you can't hear, and not bothering.
>
> Piglet,
> Pooh's Little Instruction Book,
> inspired by A. A. Milne

These concepts, particularly the value associated with “doing nothing”, are straightforward in nature but deceptively difficult to accomplish. The media and our peers feed us a steady stream of stories and data points that nudge us to take action when we shouldn’t. Fortunately, there have been some recent articles highlighting the success of investors who have embraced a simpler path. One such article from the Wall Street Journal, entitled “What Does Nevada’s $35 Billion Fund Manager Do All Day? Nothing” showcases the daily routine of the investment chief of the $35 billion State of Nevada employees’ pension plan. He single-handedly oversees the investments of the massive pension plan using a simple philosophy of keeping costs low, not trying to beat markets and when it comes to trading, doing “as little as possible, usually nothing.” While some have mocked his approach, the article states that the plan’s long-term returns have outpaced many of its peers, who often employ dozens of analysts using complex strategies.

As always, we welcome your questions and comments.

P.S. If you’ve read this far, and you or someone you know would like to know more about the food allergy research I have referenced here, I’d love to share our respective experiences.

Sincerely,

Chuck Carroll, CFA, CAIA
Chief Investment Officer
TFO Phoenix, Inc.

[1] ”Predictive Power of Fees; Why Mutual Fund Fees are So Important” Morningstar, May 2016.

[2] ”Luck vs. Skill in the Cross-Section of Mutual Fund Returns”, Eugene Fama and Kenneth French, Journal of Finance, October 2010. The Doctor Who Championed Handwashing And Briefly Saved Lives”, by Rebecca Davis, NPR, January, 12, 2015.

[3] ”Quantitative Analysis of Investor Behavior” Dalbar, 2016

[4] ”Vanguard Advisor’s Alpha”, Vanguard, June, 2016